IN THE

United States Circuit Court of Appeals

IN AND

FOR THE NINTH CIRCUIT

JOHN A. ROEBLING'S SONS COMPANY OF CALIFORNIA and I. P. MORRIS COMPANY,

Appellants,

vs.

IDAHO RAILWAY LIGHT & POWER COMPANY, O. G. F. MARKHUS, Receiver of said Company, GUARANTY TRUST COMPANY, Trustee, ELECTRIC INVESTMENT COMPANY, AMERICAN STEEL AND WIRE COMPANY, GENERAL ELECTRIC COMPANY and WESTINGHOUSE ELECTRIC AND MANUFACTURING COMPANY,

Appellees.

No. 2813

APPELLANTS' OPENING BRIEF.

BEVERLY L. HODGHEAD,
Attorney and Solicitor for Appellants.

IN THE

United States Circuit Court of Appeals

IN AND

FOR THE NINTH CIRCUIT

JOHN A. ROEBLING'S SONS COMPANY OF CALIFORNIA and I. P. MORRIS COMPANY,

Appellants,

vs.

IDAHO RAILWAY LIGHT & POWER COMPANY, O. G. F. MARKHUS, Receiver of said Company, GUARANTY TRUST COMPANY, Trustee, ELECTRIC INVESTMENT COMPANY, AMERICAN STEEL AND WIRE COMPANY, GENERAL ELECTRIC COMPANY and WESTINGHOUSE ELECTRIC AND MANUFACTURING COMPANY,

Appellees.

No. 2813

APPELLANTS' OPENING BRIEF.

STATEMENT OF THE CASE.

This is an appeal from a decree of the District Court of the United States for the Southern District of Idaho, Southern Division, denying certain claims of preference asserted by appellants herein for material and supplies furnished to the appellee, the Idaho Railway Light & Power Company, within a reasonable time before the appointment of Receiver for that corporation. On December 23d, 1913, the Westinghouse Electric & Manufacturing Company, a corporation, a creditor of the railway company, filed in said Court a bill of complaint praying that a receiver be appointed. The railway company, the defendant, on the same day, filed its answer expressly admitting all the allegations of the bill, and *"prays that the Court may appoint a receiver as prayed for in plaintiff's complaint."* The answer was signed by O. G. F. Markhus, general manager of the railway company. On the same day, and upon filing the answer, an order was entered appointing said O. G. F. Markhus, general manager of the company, Receiver thereof. The bill of complaint, the terms of which were admitted by the answer, alleged in substance that the Idaho Railway Light & Power Company was a corporation having a large capital stock, of which $16,000,000 thereof was outstanding; that it had created a bonded indebtedness of $30,000,000 secured by mortgage, of which $7,255,000 had been issued and

was outstanding; that the company had acquired from various corporations many railroad properties and hydro-electric power plants and transmission and distribution lines, and had consolidated such power and traction properties with all extensions thereof into single systems respectively, and "that said traction "properties are likewise operated as a single and in- "terdependent system and the properties heretofore "belonging to different companies have been unified, "not only in control and management but in physical "connections and extensions, so that what were for- "merly three separate operating companies and "properties are now in fact one, and the lines of de- "marcation between them have been obliterated" (Tr., p. 12); that by this interdependent and unified system, the defendant railway company supplied transportation, light and power to a large territory, and many cities and towns in the counties of southwestern Idaho.

After the appointment of Receiver, and on the 14th day of January, 1914, the Guaranty Trust Company of New York, Trustee, began suit in the same Court to foreclose the mortgage, securing an authorized issue of $30,000,000 of bonds, of which $8,449,000 were outstanding. This latter suit was docketed as No. 470 of said Court; the proceeding for appointment of Receiver was docketed as No. 468. On January 19, 1914, the two causes were consolidated by order of Court under the number and title of said cause No. 470, and

the receivership extended to embrace the foreclosure proceeding.

Said bill of foreclosure set forth in detail the corporate capacity of the parties to the action, the jurisdiction of the Court, the execution of the mortgage to secure the payment of $9,095,000 of bonds, the conditions of the mortgage, the breach of the covenants, the minute and detailed description of the properties grouped generally under various classifications, which are set out in the transcript at pages 95 to 99; and further concerning said properties alleged as follows (Tr., pp. 99 and 100):

> *"that said properties, real and personal, constitute a single, indivisible Hydro-electric power system, including stations, substations, transmission and distribution lines, and a single, indivisible electric street and interurban railway system, with properties appurtenant to, and used in connection with, said power and railway properties."*

The bill of intervention of appellant John A. Roebling's Sons Company of California, and the cross bill of appellant I. P. Morris Company, for priority or preference over claims of the mortgage creditor, were thereafter filed in said consolidated causes and issue joined thereon. Trial was had and while said claims were under submission, the Court, on December 17, 1914, made an order dismissing without prejudice the said suit to foreclose the mortgage, it having determined that the period of grace allowed by the terms

of the mortgage, after default in the payment of interest, had not expired when the bill was filed, and that the action was therefore premature. Prior to such dismissal, all the parties concerned in the consolidated actions entered into a stipulation, confirmed by the Court's order of dismissal, "that claims to preference " heretofore made by intervention or otherwise, and " all proceedings had thereunder shall not be preju- " diced by such dismissal" (Tr., p. 100). Immediately following the order of dismissal, the Guaranty Trust Company of New York, on December 17, 1914, filed a new bill of foreclosure in substantially the same form as that which was dismissed and covering the same property, and containing the same allegations, but alleging other defaults subsequently accruing. This cause was docketed as No. 517 but was never consolidated with No. 468.

Prior to the decree of the Court on the claims of preference herein involved, a decree of foreclosure and sale was entered in the action No. 517 on April 19, 1915, adjudging that the outstanding bonds secured by mortgage on which default had been made, were of the accrued value of $8,449,000, and sale of the properties by the Special Master appointed for the purpose followed on June 21, 1915. It was provided in said decree of foreclosure and sale (Tr., p. 107) that "the said lien of plaintiff and any sale hereunder " and the proceeds thereof, as hereinafter provided " are . . . also subject to all claims and demands

" which may be awarded priority to the claim of the " plaintiff herein, against said Receiver, and said es- " tate, in said Cause No. 468, or in any said suits " against said Receiver, as the same may have been " or may hereafter be adjudged and determined either " by this Court, or any Court in which said suits may " lawfully be pending, or upon any appeal, lawfully " taken from any decree of this Court in said Cause " No. 468, or of this Court or any other Court in said " plenary or independent suits"; and referring in terms to the intervening claims of appellants herein.

Thereafter on the 20th day of December, 1915, the Court entered its final decree in Cause No. 468, denying the claims of preference of appellants, from which decree this appeal is taken.

CLAIM OF APPELLANT JOHN A. ROEBLING'S SONS COMPANY OF CALIFORNIA.

John A. Roebling's Sons Company of California, a corporation, on March 25, 1915, filed in the above cause its bill of intervention setting forth its claim for preference in the distribution of the income, or proceeds of sale of the mortgaged properties. Said bill alleged in substance the corporate capacity of the parties to the proceeding, that the railway company was the owner of various systems of urban and interurban railways and power plants, transmission and distribution lines and properties which have heretofore been referred to, the appointment of a receiver,

the filing of the bill of foreclosure, and its statement of account against the said railway company for a balance due, with interest, of $22,003.63, for materials and supplies sold and delivered to said railway company, and alleging as the basis of its claim for preference as follows (Tr., pp. 34 and 35):

> "That the said merchandise and material and supplies sold by intervenor to said defendant, as herein alleged, consisted of copper wire to be used in the construction, maintenance and repair of some of the electric or power transmission lines of said defendant, above referred to, and at the time of the sale thereof the said wire was necessary for use of said defendant in the construction, alteration or repair of said power transmission lines of said defendant and that said wire was actually used in the construction and repair, and is still being used in the maintenance and operation of said electric or power transmission systems of said defendant and all of the same is, and at all times since the sale thereof was, necessary to the continued maintenance and operation of the power transmission systems of the defendant, and the earnings of said property in the possession of said Receiver or the portion thereof in the construction of which the material herein referred to was used, are derived from the use of said material so sold to defendant, as herein alleged, and without which said properties could not be operated or any earnings derived therefrom.
>
> "That all of said material and supplies sold, furnished and delivered to said Idaho Railway

Light and Power Company, as herein alleged, were necessary for the use of said corporation in keeping and preserving the said mortgaged property, or some part thereof, in operative condition and were necessary to the maintenance and operation thereof, and said material and supplies did thereby enhance the value of said property and added to the security of the bondholders thereof and said account of said intervenor for said material and supplies was one of the current debts and expenses of the maintenance and operation of said property."

Said bill of intervention further charged, and was chiefly based upon the claim, that a large amount of income received and earned during the time said material and supplies were being furnished and much greater than sufficient to pay all claims of preference asserted herein, were, before it became subject to the lien of the mortgage, diverted for the payment of interest on the said bonded indebtedness of the railway company; and that but for such wrongful diversion the accounts of appellants herein would have been paid from such earnings, as was intended by the parties at the time the material was furnished (Tr., par. IX, pp. 36 and 37).

The material allegations of the intervener's bill were denied by the Guaranty Trust Company, for lack of information, but the railway company and its Receiver entered into a stipulation of facts with intervener with

reference to the allegations of the bill. The Guaranty Trust Company did not join in this stipulation, but the Receiver was called as a witness in the case and testified that all the facts set forth in the Stipulation of Facts were true, and neither this nor his further testimony in the case was contradicted. "The prin-" cipal facts are incorporated in a written stipulation " to which is added the uncontradicted testimony of " the Receiver" (Decision of Court, Tr., p. 135).

The allegations hereinbefore quoted from the bill for the appointment of Receiver regarding the consolidation and unification of all of the properties of the railway company into a single interpendent system for purposes of operation were found by the Court to be true (Tr., p. 149).

THE ADMITTED FACTS.

From the Agreed Statement of Facts, the findings of the Court and the uncontradicted evidence of the Receiver, the following facts are in substance established.

> That the Railway Company was engaged in the maintenance and operation of street railways, interurban electric lines and power and lighting plants, and at the time of the purchase of the material and supplies described in the intervener's claim, it was deriving a large income, profit and earnings from the operation of said roads and plants. Between the 18th of March and 30th of May, 1913,

the intervener sold and delivered to the Railway Company, which was then a going concern, the material and supplies mentioned in its bill, on the open current account of the Railway Company in the belief and with the intention on its part *that the same should be paid out of the current operating income.* It was agreed between the parties that the sale was to be a cash transaction within ordinary commercial usage and the agreed price should be so paid on bills rendered within thirty days from delivery. The claim was payable on or before June 1st, 1913. The total amount of the claim was $38,577.17, on which the sum of $17,-519.80 only was paid, leaving a balance due in the sum of $21,057.37, together with $946.26 in interest. *On the 1st day of June the Railway Company took $115,550 from the current funds of the company wholly derived from earnings* and available for paying intervener's claim and paid interest upon the bonds held by plaintiff herein, and on the underlying bonds of the Boise & Interurban Railway Company and of the Boise Railroad. The total amount of interest paid on the various bonds, as shown by the stipulation, is as follows (Agreed Statement of Facts, pages 43-44):

Interest paid June 1st, 1913, on	
Bonds held by the Guaranty Trust Co.,	$165,750
Bonds of Boise & Interurban Railway Co.,	26,825
Bonds of Boise Railroad,	9,725
Total interest paid,	$202,300

The above total of interest paid was derived from the following sources:

Earnings of the Idaho Railway Co.,	$115,550
From sale of bonds,	56,750
Note of Kissel, Kinnicutt & Co.,	30,000
Total	$202,300

The following sums derived from earnings intended for payment of appellants' claims were diverted on June 1st, 1913, and paid as interest on bonds held chiefly by the Guaranty Trust Company (Tr., p. 44).

Paid on bonds of Guaranty Trust Co.,	$79,000
Paid on bonds of Boise & Interurban Ry. Co.	26,825
Paid on bonds of Boise Railroad Co.	9,725
Total interest paid from earnings,	$115,550

It further appears that at the time the material and supplies were furnished, the Railway Company was engaged in the extension of its lines, and to meet the demands for its service, was constructing

an additional transmission line from its central station at Swan Falls to the pumping plant of the Gem Irrigation District, a distance of about thirty miles, with a branch extension of four miles to the Guffey pumping station. Prior to this time the Railway Company had transmission lines extending from its generating plant to various cities and mining districts in Canyon, Ada and Owyhee counties, Idaho. During the fall of 1912 and the winter of 1913, it was enlarging the capacity of its Swan Falls plant. The transmission line to the Gem District "was constructed from Swan Falls " Station for *the purpose of serving irrigation cus-* " *tomers with whom contracts had been made,* ". . . . with a view to utilizing the increased " capacity of the Swan Falls Central Station as " thus enlarged."

At the same time the Railway Company was likewise interested in the properties of the Idaho-Oregon Light & Power Company and consequently in the development of the business of that company. The Idaho-Oregon Company had made various service contracts, largely for irrigation, involving the construction of a number of extensions, varying from one to six miles in length, *"and being* " *of the character of ordinary service extensions* " such as any power company engaged in the con- " duct of its business as a public service corpora- " tion would be expected and required to make

"from year to year as its territory developed." Some of the material purchased from intervener by the Railway Company was, for the above reason, furnished to the Idaho-Oregon Company under the agreement called an "equipment trust."

All of the material and supplies so furnished by intervener were used and devoted to the purposes set forth in the agreed statement of facts which may be epitomized as follows:

General extension service,	$1121.15
Swan Falls installation,	91.82
"Equipment Trust Agreement,"	10546.64
Transmission line to Gem District,	26817.56
Total	38577.17
Paid	17519.80
Balance	21057.37
Interest	946.26
Total	22003.63

The agreement statement contains the following:

"It is further stipulated that all of said wire has been actually delivered by the intervener to the Railway Company and devoted by the Railway Company to the purposes above specified and is in use by the Railway Company (or by the Idaho-Oregon Company under said 'Equipment trust

agreement'), as a part of its existing system, *and has become a part of the Railway Company's system, has enlarged the same, and has contributed to the earnings, and to the value of the properties, and the security of the bonds, and said material is and was necessary to the continued maintenance and operation of the respective parts of said property for which the same was supplied and in which it is used."*

It is admitted by the complaint of bondholders in foreclosure herein, at page 78, paragraph ninth, as follows, referring to all of the properties of said Railway Company as described therein:

"That said properties, real and personal, *constitute a single indivisible hydro-electric power system,* including stations, sub-stations, transmission and distribution lines, *and a single indivisible electric street and interurban railway system* with properties appurtenant to and used in connection with said power and railway properties."

It appears also from the statement of evidence in the case that the bonds under foreclosure in this case were owned in most part by a syndicate of bankers in New York managed by the firm of Kissell, Kinnicutt & Company (Tr., p. 129). Mr. Samuel L. Fuller, connected with that firm, is the head of the syndicate, and was also the Managing Director of the Idaho Railway Light & Power Company itself (Tr., p. 118). The Receiver, who was the local manager of the com-

pany, testified concerning the Roebling claim, "We "were under obligations to furnish power to the Gem "District. That is why we rushed the order, or "rather, were in haste to get the material for build- "ing that line. The order was placed here. *I don't "recall who instructed me to give the order, but we "got instructions from New York"* (Tr., p. 118).

CLAIM OF I. P. MORRIS COMPANY, APPELLANT.

The cross bill of appellant I. P. Morris Company in the nature of an intervening petition, contained preliminary allegations similar to the Roebling Bill, and alleged that pursuant to a contract made in 1912, the Morris Company did within six months prior to the appointment of Receiver, furnish material and perform labor in connection with its installation required in the operation of the Swan Falls Power Plant for the generation of electric energy upon which open account there was a balance due and unpaid of $27,023.31. Notes had subsequently been taken as evidence of indebtedness but not received in payment. Its claim for the equitable preference for the above amount is asserted in paragraphs IV and V of the bill as follows:

IV.

"That the machinery so furnished by this cross-complainant was used by the said Railway Company in the construction, maintenance and repair of its hydro-electric power plant, situated at Swan

Falls on Snake River in Owyhee County, Idaho, and the labor so done and performed by this cross-complainant in connection with the installation of said machinery was in connection with the repair of said hydro-electric power plant; that such machinery and labor was necessary for the use of said Railway Company in the construction, operation, maintenance and repair of said plant, and ever since the installation of said machinery and for several months last past the same has been used by said Railway Company and is now being used by the Receiver thereof for generating electric current furnished by the Railway Company and by said Receiver to the public and to the communities served by said Railway Company and its Receiver for operating the electric railway lines and cars owned and operated by said Railway Company.

"That without such machinery and labor so furnished and rendered by this cross-complainant, the Railway Company and its said Receiver would be unable to furnish electric power to its customers and to the communities served by such Company for heating, lighting, or other purposes, or for the operation of its railroad, city and interurban lines, or for discharging its duties as a public service corporation; and such Railway Company and its Receiver would be unable to maintain and protect the franchises held and enjoyed and described in the amended complaint of the Guaranty Trust Company of New York, Trustee, in its suit for the foreclosure of its mortgage or deed of trust."

V.

"That the earnings of the Railway Company ever since the installation of said machinery, and the income and earnings of the property now in the possession of said Receiver, are largely, if not entirely, derived from the use and operation of the machinery so furnished and installed by this cross-complainant; and such machinery and the labor performed by the cross-complainant have greatly enhanced the value of the property of said Railway Company and the estate in the possession of said Receiver. That the income and earnings of the Railway Company and of said Receiver from the machinery so furnished and from the labor so performed by this cross-complainant, have been diverted and used for the payment of interest on the bonds issued by the Railway Company under the mortgage or deed of trust sought to be foreclosed by the Guaranty Trust Company of New York, Trustee, as aforesaid. That the earnings from such property aggregate a sum largely in excess of the amount due this cross-complainant, and if the same had been applied to the payment of this cross-complainant's account, as it should in equity and good conscience have been applied, it would long since have fully discharged and satisfied the claims of this cross-complainant, as aforesaid; but the earnings of such property, due to the furnishing of such machinery and the performance of such labor by this cross-complainant, have been diverted and used for other purposes, and particularly for the payment of interest on the bonds secured by the mortgage

sought to be foreclosed by said Guaranty Trust Company of New York, and the amount so diverted and misapplied to the payment of such interest is largely in excess of the amount due this cross-complainant."

The material parts of this cross bill were denied by the Guaranty Trust Company for lack of information, but appellant and the Receiver likewise entered into an Agreed Statement of Facts, from which it substantially appears as follows:

That the account, for which claim of preference is sought, is correct; that the machinery supplied was used by the Railway Company in improving, enlarging and in part rebuilding the Swan Falls Power Plant "by removing three 300 K. W. generating units, replacing the same by two 1250 K. W. generating units, with the necessary foundation, wheel pits, gates, and tail races all so arranged and placed that two additional 1250 K. W. can be installed in the future . . . That the enlargement and improvement made at the Swan Falls plant under the Morris contract was for the purpose of putting the Railway Company in a condition to better serve its customers and to supply the increasing demand for electric current for the purposes stated."

That the material was received by the Railway Company prior to the 1st day of June, 1913, but the installation was not completed or accepted until within six months of the appointment of Receiver.

Substantially the same admission is made regarding the diversion of earnings for the payment of interest on bonds as is found in the Roebling stipulation, and the Agreed Statement of Facts further contains the following admission (Tr., p. 72):

"(k) It is agreed that the machinery furnished to the Railway Company is worth the price thereof and that it has become a part of the corporate properties and assets of the Railway Company, and has added to the security of the plaintiff's mortgage by an amount equal to such cost and value, and that such machinery is necessary to the continued operation of the Railway Company's system, and that without it it could not perform its duties to the public; and that said material was furnished and work performed by Morris for the Railway Company in the belief and intention that the same, unless otherwise provided for by the Railway Company, would be paid for out of the operating or current income thereof."

The Court by its final decree denied preference upon both claims, adhering strictly to the so-called "six-months' rule" in the Roebling case and holding that the material supplied under both claims was not for necessary maintenance and operating expenses but was chargeable to construction.

The principal assignment of error and the chief reliance for reversal of the decree are based upon the wrongful diversion of the income, and the fact that considering the extensive and comprehensive sys-

tem of properties owned and operated by the Railway Company, the value of its plant and the amount and value of its securities, the work done was nothing more than ordinary service extensions and improvements and repairs, and properly chargeable to maintenance and operation. The claimants appealed to this Court and assigned, and now assign, as error the following:

ASSIGNMENTS OF ERROR ON JOHN A. ROEBLING'S SONS COMPANY'S APPEAL.

I.

Said Court erred in denying and disallowing said claim of John A. Roebling's Sons Company of California as a preferred creditor of said Idaho Railway Light & Power Company, and over the claims of the general creditors of said Idaho Railway Light & Power Company and of the Guaranty Trust Company of New York, Trustee, and of the mortgage bondholders referred to in said decree:

II.

Said Court erred in refusing to direct the payment of said account of John A. Roebling's Sons Company of California for $21,057.37 against said Idaho Railway Light & Power Company and the whole thereof from the income received by the Receiver of said Railway Company from the operation of said properties thereof described and referred to in said decree,

and in denying and disallowing the said claim of said appellant for priority or preference in payment thereof from said income, as prayed for in said Bill:

III.

That said Court erred in refusing to direct the payment of said account of appellant herein from the proceeds of the sale of said property by the Special Master under decree of foreclosure of mortgage in the action No. 517 instituted by the Guaranty Trust Company of New York, Trustee for the mortgage bondholders, as referred to in said decree herein, and in denying and disallowing said claim of appellant for priority and preference of payment from the proceeds of said sale over and above the claims of the said Guaranty Trust Company of New York, as trustee and plaintiff in said action;

IV.

That said Court erred in ordering, adjudging and decreeing that said claim of John A. Roebling's Sons Company of California, a corporation, appellant herein, was inferior and subordinate in right to the claims of the Guaranty Trust Company of New York under the decree in favor of said Trustee in said cause No. 517;

V.

That said Court erred in ordering, adjudging and decreeing that the said claim of appellant herein is not a lien against any of the property covered by said decree of foreclosure in said cause No. 517 and belonging to said Idaho Railway Light & Power Company, defendant herein, and in ordering, adjudging and decreeing that said property in the hands of the Electric Investment Company, the purchaser thereof at the foreclosure sale, is free from any lien and that said claim of appellant herein was only enforcible to the extent that there were assets available for the payment thereof as prescribed in said decree, to wit, to the extent of three and 22-100 cents (.0322) on each dollar of said claim.

VI.

Said Court erred in holding, determining and adjudging that the claim of said John A. Roebling's Sons Company of California, the intervener, was not entitled to preference over the lien of the pre-existing mortgage or trust deed of the Guaranty Trust Company of New York because the material and supplies out of which said claim arose were not furnished or supplied within six months prior to the institution of the receivership in said above entitled cause.

VII.

The Court erred in holding, determining and adjudging that the said claim of John A. Roebling's Sons Company of California, appellant herein, was not entitled to preference over the pre-existing mortgage or trust deed of the Guaranty Trust Company of New York because the material and supplies furnished by said intervener, out of which said claim arose, were furnished for new construction and not for repair or maintenance of the existing plant of said defendant Railway Company and in the ordinary operation and maintenance of said property.

VIII.

Said Court erred in ordering and adjudging by said decree that the income of said receivership received, and all collections of cash made by said Receiver subsequent to the date of the filing of said petition or bill of said Guaranty Trust Company of New York for the foreclosure of said mortgage on the 19th day of December, 1914, be impounded for the benefits of said Guaranty Trust Company of New York and the bondholders represented by it, and adjudging that the right of said Guaranty Trust Company of New York, said Trustee, in and to said income and collections was superior to the rights and claims of appellant herein.

IX.

Said Court erred in adjudging and decreeing that the balance of cash deemed to be on hand to apply on the claims of general creditors was $156,464.06, and in refusing to add to said fund the income from said receivership after said 19th day of December, 1914.

ASSIGNMENTS OF ERROR ON I. P. MORRIS COMPANY'S APPEAL.

I.

Said Court erred in denying and disallowing said claim of I. P. Morris Company as a preferred creditor of said Idaho Railway Light & Power Company, and over the claims of the general creditors of said Idaho Railway Light & Power Company and of the Guaranty Trust Company of New York, Trustee, and of the mortgage bondholders referred to in said decree;

II.

Said Court erred in refusing to direct the payment of said account of I. P. Morris Company for $26,844.21 against said Idaho Railway Light & Power Company and the whole thereof from the income received by the Receiver of said Railway Company from the operation of said properties thereof described and referred to in said decree, and in denying and disal-

lowing the said claim of said appellant for priority or preference in payment thereof from said income, as prayed for in said Bill;

III.

That said Court erred in refusing to direct the payment of said account of appellant herein from the proceeds of the sale of said property by the Special Master under decree of foreclosure of mortgage in the action No. 517 instituted by the Guaranty Trust Company of New York, Trustee for the mortgage bondholders, as referred to in said decree herein, and in denying and disallowing said claim of appellant for priority and preference of payment from the proceeds of said sale over and above the claims of the said Guaranty Trust Company of New York, as trustee and plaintiff in said action;

IV.

That said Court erred in ordering, adjudging and decreeing that the said claim of I. P. Morris Company, a corporation, appellant herein, was inferior and subordinate in right to the claims of the Guaranty Trust Comapny of New York under the decree in favor of said Trustee in said cause No. 517;

V.

That said Court erred in ordering, adjudging and decreeing that the said claim of appellant herein is

not a lien against any of the property covered by said decree of foreclosure in said cause No. 517 and belonging to said Idaho Railway Light & Power Company, defendant herein, and in ordering, adjudging and decreeing that said property in the hands of the Electric Investment Company, the purchaser thereof at the foreclosure sale, is free from any lien and that said claim of appellant herein was only enforcible to the extent that there were assets available for the payment thereof as prescribed in said decree, to wit, to the extent of three and 22-100 cents (.0322) on each dollar of said claim;

VI.

Said Court erred in holding, determining and adjudging that the claim of said I. P. Morris Company, the cross-complainant, was not entitled to preference over the lien of the pre-existing mortgage or trust deed of the Guaranty Trust Company of New York because the material and supplies out of which said claim arose were not furnished or supplied within six months prior to the institution of the receivership in said above entitled cause.

VII.

The Court erred in holding, determining and adjudging that the said claim of I. P. Morris Company, appellant herein, was not entitled to preference over the pre-existing mortgage or trust deed of the Guaranty Trust Company of New York because the ma-

terial and supplies furnished by said cross-complainant, out of which said claim arose, were furnished for new construction and not for repair or maintenance of the existing plant of said defendant Railway Company and in the ordinary operation and maintenance of said property.

VIII.

Said Court erred in ordering and adjudging by said decree that the income of said receivership received, and all collections of cash made by said Receiver subsequent to the date of the filing of said petition or bill of said Guaranty Trust Company of New York for the foreclosure of said mortgage on the 19th day of December, 1914, be impounded for the benefit of said Guaranty Trust Company of New York and the bondholders represented by it, and adjudging that the right of said Guaranty Trust Company of New York, said Trustee, in and to said income and collections was superior to the rights and claims of appellant herein.

IX.

Said Court erred in adjudging and decreeing that the balance of cash deemed to be on hand to apply on the claims of general creditors was $156,464.06, and in refusing to add to said fund the income from said receivership after the said 19th day of December, 1914.

ARGUMENT.

(In all quotations the italics are ours.)

It is respectfully urged that the claims of appellants possess all of the elements which entitle them to an equitable preference over the lien of the bondholders, viz.:

FIRST: The claims are for what is denominated by the Agreed Statement of Facts as "material and supplies," and were furnished within a reasonable time allowed by the rule established by the decisions prior to the appointment of the Receiver.

SECOND: The material and supplies were furnished to a public service corporation, namely, a railway, light and power company, in the continued operation of which the general public is interested.

THIRD: It is agreed, and is the uncontradicted fact, that *the material and supplies were necessary to the continued maintenance and operation of the railway company's property.*

FOURTH: That it was sold on an open current account for cash and in the belief that it would be paid for *"out of the current operating income,"* or earnings of the corporation.

FIFTH: All of said material *"has become a part of the railway company's system, has enlarged the same*

and has contributed to the earnings and to the value of the properties and to the security of the bonds," and is a part of the property which was sold under the decree of foreclosure.

SIXTH: *The current operating income to the amount of $115,550 on hand June 1st, 1913, derived solely from earnings and available for payment of said claims, was, through the agency of the Syndicate which owned or controlled the bonds, managed all the financial affairs of the Railway and also directed the purchase of the material, diverted from that fund and used for the payment of interest upon its own bonds, and the sum so diverted was never restored.*

Appellants respectfully contend that it would be highly inequitable, under the above conditions, for the bondholders to escape payment of these claims and yet retain both the property furnished by the appellants and also the money or current income derived from the earnings and intended for their payment, and which was diverted by them to pay interest on their own bonds. Yet the evidence in the record fairly establishes that the above statement is true, and that Mr. Samuel L. Fuller, of Kissel, Kinnicutt & Company, of New York, the manager of the bondholders' syndicate, was also the active managing director of the Idaho Railway Light & Power Company, and had charge of the administration of its financial affairs,

not only at the time the material was purchased but at the time of the diversion of the income for the payment of interest and also when the Receiver was appointed.

> "Mr. Fuller was the head of the syndicate" (Testimony of O. G. F. Markhus, Receiver, Tr., p. 118).

> "That syndicate is managed by my firm, as syndicate managers" (Testimony of Samuel L. Fuller, Tr., p. 129).

> "Samuel L. Fuller is the vice-president of the Railway Company, and with respect to finances he was in fact its managing director" (Testimony of Receiver Markhus, Tr., p. 118).

> "The order (for material) was placed here. I don't recall who instructed me to give the order, *but we got instructions from New York*" (Testimony of Receiver Markhus, Tr., p. 118).

The order on June 1st to divert the earnings of the Railway Company, available for the payment of appellants' claims, to the payment of the interest on the bonds, must also have come from the management which owned the bonds. Stated more clearly, the manager of the bondholding syndicate, who was also the Vice-President and managing director of the Railway Company, himself was responsible for the purchase of the material, which was to be paid for

out of the earnings, and almost immediately thereafter diverted the earnings to the payment of the interest on his own bonds; and a few weeks over six months thereafter, joined in the petition for the appointment of the Receiver. Among all the cases upon this subject we think none will be found in which the creditor has been denied payment and the bondholder permitted to retain the benefit, where all of the elements of preferential claims above outlined have been present. On the other hand, it will be found that wherever preference has been denied upon a claim which could reasonably be construed to be for necessary material and supplies, which is here admitted, it has been where either some or all of the above elements have been lacking. In most of them there has been no diversion of the income. In many, the claims added nothing to the value of the property, or the security of the bonds, or the property was not included in the foreclosure sale. In others, the material and supplies were not necessary to the continued maintenance and operation of the company's property, as is stipulated to be the fact in this case.

GROUNDS OF EQUITABLE PREFERENCE.

The doctrine of equitable preference has been based upon various grounds. In some cases it is said that where the mortgagee invokes a court of equity for the appointment of receiver, he must do equity and the Court has power to direct the payment of such claims

as in equity and good conscience should be paid. In others, the preference is said to be based upon the necessity of the maintenance of a public service corporation as "a going concern," and that it is essential to the convenience of the public that such corporation have credit for its necessary labor, material and supplies; that the mortgagee of the property of such corporation by implication consents to the payment of such indebtedness, and more especially is this true in the instance of a wrongful diversion of funds from the earnings for the benefit of the mortgagee.

THE CHARACTER OF PUBLIC SERVICE CORPORATIONS TO WHICH THE DOCTRINE OF EQUITABLE PREFERENCE BELONGS.

The principle applies to all public service corporations. There is no greater necessity for maintaining railroads as going concerns for the convenience of the public than any other quasi-public corporation. The doctrine is certainly not limited to steam railroads for, if so, it would vanish when that form or mode of power is supplanted by electricity. The question really does not arise in this case because the Idaho Railway Light & Power Company is a railway company engaged in the operation of "urban and suburban railway lines in the State of Idaho," and as above stated, the complaint (page 78) alleges that its properties constitute a *single indivisible unit.* The defendant does not lose its character as a railway com-

pany because in addition to the operation of railway lines it generates its own power.

THE AGE OF CLAIMS UPON WHICH PREFERENCE MAY BE ALLOWED.

There is no fixed rule established by the decisions as to the age of claims which may be entitled to a preference. In some circuits it has been customary for the court in the *original* order appointing a receiver, to direct the payment of claims for materials and supplies furnished within six months prior thereto, and this practice has given rise to the so-called "six months' rule." But the courts in the trial of *contested causes* have not been bound by this limitation, except, we may add, in the Eighth Circuit.

The origin of the so-called "six months' rule" is thus explained in *Foster's Federal Practice,* 5th edition, Volume I, Sec. 305, at page 962, where it is said:

> "The practice arose in the Seventh Circuit to impose as a condition upon the appointment of a receiver in a suit for the foreclosure of a railroad mortgage, that debts for materials and supplies and labor furnished to the mortgagor within the six previous months be paid out of the net income, or in some cases out of the proceeds of the sale of the road, before the debt secured by the mortgage. *This is called 'the six-months' rule.'*"

On page 969 of the same authority, it appears that claims due for the following periods prior to the

appointment of receiver have been allowed a preference:

Eight months.

Skiddy v. *Atlantic Railroad Co.,* 3 Hughes, 320.

Eleven months.

Southern Railway Co. v. *Carnegie Steel Co.,* 176 U. S., 257;
Burnham v. *Bowen,* 111 U. S., 776.

Two years.

Central Trust Co. v. *Wabash Railroad Co.,* 30 Fed., 332, 334;
Farmers Trust Co. v. *Kansas City,* 53 Fed., 182.

Three years.

Hale v. *Frost,* 99 U. S., 389.

In the Ninth Circuit, in the case of *New York Guaranty & Indemnity Co.* v. *Tacoma Railroad Co.,* 83 Fed., 365, preference was allowed upon a claim for the price of a cable *for a cable street railway* purchased more than two years before the appointment of a receiver. This Court said, quoting from the syllabus, "Such priority may be allowed though more than *two years* elapsed between the time the cable was furnished and the appointment of a receiver."

We respectfully contend that the above decision fixes the rule for this Circuit. The case has not been over-

ruled, but the appellee will urge that it is inconsistent with *Spencer* v. *Taylor,* 194 Fed., 635. In that case, a claim contracted about a year prior to the appointment of receiver was denied for reasons stated in the opinion, but the Court did not assume to announce a hard and fast rule that preference would be denied after six months, and manifestly it could not do so, as that question was not before it.

The material and labor upon which the I. P. Morris Company claim is based was furnished and supplied within six months before the appointment of Receiver, and the question does not arise in respect to that Company's claim. The claim of the Roebling's Sons Company was incurred about seven months before the appointment of Receiver, that is, it was supplied between the 18th of March and the 30th of May, and payable thirty days from delivery of the various items. It will be seen that it was just outside of the six-months' limitation.

In the case of

> *New York Guaranty & Indemnity Co.* v. *Tacoma Railroad Co.,* 83 Fed., 365,

above quoted, this Court said, page 370, quoting from the *Railroad Co.* v. *Lamont:*

> *"'A preferential debt is not barred, though contracted more than six months before the appointment of a receiver. As to such debts, there is no*

arbitrary six-months' rule, as has been often decided.'"

On the same page this Court further said:

"In the case cited the indebtedness accrued *more than six months* before the receivership. In *Atkins* v. *Railroad,* 3 Hughes, 307, Fed. Cas. No. 604, the claim was 22 months old at the time of the appointment of the receiver. In the case of *Hale* v. *Frost,* 99 U. S., 389, the supreme court gave priority to a claim for materials furnished 3 years before the appointment of the receiver, and for which a note had been given 16 months before the receiver was appointed. In *Burnham* v. *Bowen,* 111 U. S., 776, 4 Sup. Ct., 675, priority was given to a claim for coal supplied 11 months before the appointment of a receiver. In *Trust Co.* v. *Morrison, supra,* a liability incurred by the intervener as surety for a railroad company on an injunction bond to stay the execution of a judgment at law against the company, executed more than 6 years before the date of the filing of the petition in intervention, was held a preferential claim. See, also *Douglass* v. *Cline,* 12 Bush., 608; *Skiddy* v. *Railroad Co.,* 3 Hughes, 320, Fed. Cas. No. 12,922; *Williamson's Adm'rs.* v. *Railroad Co.,* 33 Grat., 624.

In the above case "the time that elapsed between " the time of the delivery of the cable and the appoint- " ment of the receiver by the state court, would there- " fore be about 26 months, or a little over 2 years. . . " Without elaborating upon the proposition any fur-

"ther, we are of the opinion that the claim for the "cable in question should be made a preferred debt."

In *Southern Railway Co.* v. *Carnegie Steel Co.,* 176 U. S., 257, the Supreme Court of the United States allowed a preference upon a claim incurred *eleven* months prior to the appointment of Receiver notwithstanding that the order of appointment contained the usual "six-months' clause."

In *Farmers Loan & Trust Co.* v. *Kansas City Co.,* 53 Fed., 182, the Court said, page 187:

> "Preferential debts, it is commonly said, are those which have aided to conserve the property, and have been contracted within some reasonable period. But just what debts aid to conserve the property, and what length of time will bar them, is not very clear upon the authorities, and depends largely upon the circumstances of each particular case. There is no fixed rule barring preferential debts contracted more than six months before the appointment of the receiver. There is no 'six months' rule.' In the case of *Hale* v. *Frost,* 99 U. S., 389, the supreme court gave priority to a claim for materials furnished 3 years before the appointment of the receiver, and for which a note had been given 16 months before the receiver was appointed. In the case of *Burnham* v. *Bowen,* 111 U. S., 776, 4 Sup. Ct. Rep., 675, the court gave priority to a claim for coal supplied 11 months before the appointment of a receiver. There are cases in the state courts also where priority has been given to debts contracted much more than

6 months before the appointment of the receiver. See note to *Blair* v. *Railway Co.*, 22 Fed. Rep., 471, 475. In the case of *Central Trust Co.* v. *St. Louis, A. & T. Ry. Co.*, 41 Fed. Rep., 551, the mortgages in suit were executed in 1886 and 1887, and the receiver was appointed in 1889 by Mr. Justice Brewer, then circuit judge; and afterwards, when the question arose as to what debts should have priority, Justice Brewer said:

"'I do not understand from the parties making the application for the receiver that there was any desire or thought of cutting off any just claims accruing during the brief period which has elapsed since their mortgage was given, and, if counsel or party had any such idea, they much mistake my judgment in the premises.'

"The period (2 years) that elapsed between the giving of the mortgage and the appointment of the receiver in that case was the same that it is in this."

The learned Judge below in the decision upon these claims stated, that it was true the six months' limitation was not always observed, but held that it must control in cases which are not substantially exceptional. In all the cases above cited the claims were not allowed because they were exceptional but because they came within the rule of equitable preference. But if it were necessary to establish the exceptional character of this claim, the evidence of it is found in the above statement of facts, which disclose the connection which the bondholders had with the

purchase of the property and the coincidence of the appointment of the Receiver a few weeks after the six months' period, upon the joint application of the Railway Company, whose managing director was the manager of the bondholders' syndicate. Where the rule is not inflexible and the margin of time, as in this case, is insignificant and no injury sustained thereby, it would seem that under all of the facts outlined above, were this the only question involved, it was a proper case for the allowance of a preference.

THE RULE OF DECISION CONCERNING THE CHARACTER OF MATERIAL AND SUPPLIES FOR WHICH CLAIMS OF PREFERENCE MAY BE ALLOWED.

Rarely has a case arisen involving the doctrine of equitable preference which does not revert to

Fosdick v. *Schall,* 99 U. S., 235.

The principles announced in that case have repeatedly been applied in later cases in State and Federal courts. What has sometimes been referred to as limitations on the doctrine there announced are not limitations, but merely warnings to the courts to see that the facts before them bring the case within the doctrine of *Fosdick* v. *Schall.* It may appear singular that in that leading case, which established the doctrine of preferential claims, a preference upon the particular claim involved was denied. But the case

should be read in connection with the companion case of

Fosdick v. *Southwestern Car Co.*, 99 U. S., 256.

In *Fosdick* v. *Schall,* the claim was for rental of cars sold to the mortgagor under an agreement reserving title until paid for. The property therefore was not added to the security of the mortgage and did not increase its value. Neither was there any diversion of income for the benefit of the mortgagee. The Court said, in the paragraph of the opinion of *Fosdick* v. *Schall:*

> "The cars were not included in what was sold at the foreclosure sale, consequently they contributed nothing directly to the fund now in court for the distribution."

And again:

> *"There is nothing to show that the current income of the receivership or of the company has been in any manner employed so as to deprive this creditor of any of his equitable rights.* In short, as the case stands, no equitable claim whatever has been established upon the fund in court."

The claim of preference was therefore denied.

In *Fosdick* v. *Southwestern Car Company,* on the other hand, the cars for which claim of preference was sought were included in the foreclosure sale and

therefore added to the value of the property and to the security of the bonds. The Court says:

> "As the cars had been included in the foreclosure sale the Clerk was directed to pay the purchase price to the intervener from the fund in court."

The general equitable considerations which justified the preference of the claim for materials and supplies before the lien of the mortgage creditor, was fully stated in *Fosdick* v. *Schall* and the rules therein given have not been departed from notwithstanding the warning in the *Kneeland* and *Thomas* cases to be referred to.

Speaking of the basis of the doctrine, the Court said:

> "The business of all railroad companies is done to a greater or less extent on credit. This credit is longer or shorter, as the necessities of the case require; and when companies become pecuniarily embarrassed, it frequently happens that debts for labor, supplies, *equipment* and *improvements* are permitted to accumulate, in order that bonded interest may be paid and a disastrous foreclosure postponed, if not altogether avoided. In this way the daily and monthly earnings, which ordinarily should go to pay the daily and monthly expenses, are kept from those to whom in equity they belong, and used to pay the mortgage debt. *The income out of which the mortgagee is to be paid is the net income obtained by deducting from the*

gross earnings what is required for necessary operating and managing expenses, proper equipment and useful improvements."

Referring to the implied contract, which is a part of every mortgage of a public service corporation, and which every bondholder is presumed to know and take subject to, the Court says:

"Every railroad mortgagee in accepting his security impliedly agreed that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim upon the income. If for the convenience of the moment, something is taken from what may not improperly be called the current debt fund, and put into that which belongs to the mortgage creditors, it certainly is not inequitable for the court, when asked by the mortgagees to take possession of the future income and hold it for their benefit, to require as a condition of such an order that what is due from the earnings to the current debt shall be paid by the court from the future receipts before anything derived from that source goes to the mortgagee. *In this way the court will only do what, if a receiver should not be appointed, the company ought itself to do.* For even though the mortgage may in terms give a lien upon the profits and income, until possession of the mortgaged premises is actually taken or something equivalent done, the whole earnings belong to the company and are subject to its control." (Citing cases.)

Referring to diversion of current funds and to the character of the claims that should be paid from such funds, the Court says that if *"it appears in the progress "of the cause that bonded interest has been paid,* addi- "tional equipment provided, or lasting and valuable "improvements made out of the earnings which ought "in equity to have been employed to keep down debts "for labor, supplies and the like, it is within the "power of the court to use the income of the receiv- "ership to discharge obligations which, *but for the "diversion of funds,* would have been paid in the "ordinary course of business."

Referring to the payment of claims out of the earnings during the receivership, or out of the proceeds of sale under foreclosure, it says:

> "While ordinarily, this power is confined to the appropriation of the income of the receivership and the proceeds of moneyed assets that have been taken from the company, cases may arise where equity will require the use of the proceeds of the sale of the mortgaged property in the same way. Thus it often happens that, in the course of the administration of the cause, the court is called upon to take income which would otherwise be applied to the payment of old debts for current expenses, and use it to make permanent improvements on the fixed property, or to buy additional equipment. In this way the value of the mortgaged property is not infrequently materially increased."

Referring to the rules that should control the court in applying the doctrine, it says:

> *"No fixed and inflexible rule can be laid down for the government of the courts in all cases. Each case will necessarily have its own peculiarities, which must to a greater or less extent influence the Chancellor when he comes to act.*
>
> *"The power rests upon the fact, that in the administration of the affairs of the company the mortgage creditors have got possession of that which in equity belong to the whole or a part of the general creditors. Whatever is done, therefore, must be with the view to a restoration by the mortgage creditors* of that which they have thus inequitably obtained. . . . . All depends upon a proper application of well settled rules of equity jurisprudence to the facts of the case, as established by the evidence."

The principle announced in the above case has peculiar application to the facts of the present case, as the administration of the affairs of the Idaho Railway Light & Power Company was not under independent management but was controlled by the mortgage creditors themselves, which enabled them, through the diversion of the earnings to pay interest on their own bonds, to secure an undue advantage and obtain "possession of that which in equity belongs to the general creditors."

Referring to the proposition that restoration is the

end sought by the Court, it is further said in *Fosdick* v. *Schall:*

> "Whatever is done, therefore, must be with the view to a restoration by the mortgage creditors of that which they have thus inequitably obtained. It follows that if there has been in reality no diversion, there can be no restoration; and that the amount of restoration should be made to depend upon the amount of the diversion."

The rule is stated in *Foster's Federal Practice* above referred to, page 957, as follows:

> "Even where no such order has been made when the receiver was appointed, if it appears *at any time* in the progress of the cause that interest has been paid, additional equipment provided or repairs of the property made out of its *earnings during a short time before the default* in interest, the court usually directs that such debts then incurred be paid out of the income of the receivership after the payment of the receiver's expenses, in preference to the claims of creditors secured by mortgage or other lien. Although usually they are paid out of the net income of the receiver, in special cases, especially where this income has been used to pay for betterments or mortgage interest by a receiver appointed in the foreclosure suit, or even by a receiver appointed in a prior suit to foreclose a junior lien, or to preserve the property for other creditors or stockholders, or by a reorganization committee representing the bond-

holders and stockholders, such claims have been ordered paid out of the proceeds of the foreclosure sale before any payment on account of mortgage bonds; and in some cases it has been made a condition of the sale that the purchaser pay these claims in addition to the nominal amount of his bid." Citing

Fosdick v. *Schall,* 99 U. S., 235;
Fosdick v. *Southwestern Car Co.,* 99 U. S., 256;
Hale v. *Frost,* 99 U. S., 389;
Miltenberger v. *Logansport Ry.,* 106 U. S., 286-308;
Union Trust Co. v. *Souther,* 107 U. S., 591;
Burnham v. *Bowen,* 111 U. S., 776;
Virginia Coal Co. v. *Central R. R.,* 170 U. S., 355;
Southern Ry. Co. v. *Carnegie Steel Co.,* 176 U. S., 257;

and other cases.

The next case after *Fosdick* v. *Schall* to come before the Supreme Court on this question was *Burnham* v. *Bowen,* 111 U. S., 776. In that case the court quotes with approval from *Fosdick* v. *Schall, supra,* to the effect that only the net income is subject to the mortgage, and that every mortgagee and bondholder impliedly agrees that the current debts shall be paid from the current receipts before any of the earnings be applied *to the payment of interest or otherwise dis-*

bursed for the benefit of the mortgagees. And the Court then adds:

> "Such being the case, when a court of chancery, in enforcing the rights of mortgage creditors, takes possession of a mortgaged railroad and thus deprives the company of the power of receiving any further earnings, *it ought to do what the company would have been bound to do if it had remained in possession; that is to say, pay, out of what it receives from earnings, all the debts which in equity and good conscience, considering the character of the business, are chargeable upon such earnings. In other words, what may properly be determined the debts of the income should be paid from the income, before it is applied in any way to the use of the mortgagees.*"

In that case the Court found that there had been no diversion of the income, but that the income was insufficient to meet the current expenses; and it was contended that as there had been no diversion there could be no restoration, and that the doctrine regarding preferential claims did not apply. As to that, the Court said:

> "The debt due Bowen was incurred to keep the road running, and thus preserve the security of the bondholders. If the trustees had taken possession under the mortgage, they would have been subjected to similar expenses to do what the company, with their consent and approbation, was doing for them. . . . Under these circumstances,

> we think the debt was a charge in equity on the continuing income, as well that which came into the hands of the court after the receiver was appointed as that before. When therefore the court took the earnings of the receivership and applied them to the payment of the fixed charges on the railroad structures, thus increasing the security of the bondholders at the expense of the labor and supply creditors, it was such a diversion of what is denominated in *Fosdick* v. *Schall* the 'current debt fund' as to make it proper to require the mortgagees to pay it back."

In that case the mortgagee, in order to avoid the application of the doctrine so as to make the corpus of the mortgaged estate liable for the payment of any claims, took a decree of strict foreclosure, leaving no fund for the payment of the preferential claims. But the circuit court made a provision that the property should be taken by the purchasers subject to preferential claims, and the mortgagee complained of this provision of the decree. This was in effect making the corpus of the estate liable for the payment of the claims. As to that, the Supreme Court said:

> "As the diversion of the fund created in equity a charge on the property as security for its restoration, it is clear that if the mortgagees prefer to take the property under a decree of strict foreclosure, they take it subject to the charge in favor of the current debt creditor whose money they have got and that he can insist on a sale of the property

for his benefit if they fail to make the payment without."

Referring to the importance, not only as to the public service corporation but to bondholders and the public, of applying a doctrine that will not interfere with the operation of the road, even though it may be in failing circumstances, the Court said:

"The maintenance of the road and the prosecution of its business were essential to the preservation of the security of the bondholders. The business of every railroad company is necessarily done more or less on credit, all parties understanding that current expenses are to be paid out of current earnings. Consequently, it almost always happens that the current income is encumbered, to a greater or less extent, with current debts made in the prosecution of the business out of which the income is derived."

In *Union Trust Co.* v. *Souther,* 107 U. S., 591, the income of the receivership, instead of being applied to the payment of debts for supplies and labor, *was used at the request of the bondholders to make permanent improvements,* thus adding to the value of the property which was afterwards sold. Upon foreclosure the Court directed payment from the proceeds of the sale, of claims arising prior to the appointment of the receiver. In connection with this order the Court said:

"The income of the receivership, instead of being applied in accordance with the order to pay

the debts for the supplies and labor, was used, *with the consent, and it may fairly be inferred, at the request of the bondholders,* to buy additional grounds, rolling stock, etc., and to make permanent improvements, thus adding to the value of the property; which was afterwards sold. There is nothing whatever to indicate that in thus using the income it was the intention of the court to revoke the original order. It seems to have been found, in the administration of the cause, that by using the income to add to the value of the fixed property the interests of all parties would be promoted, and so the fund, which in equity belonged to the labor and supply creditors, was for the time being diverted from them and put into improvements and additions, the proceeds of which are now in court. It is not to be presumed that this diversion would have been authorized if the value of the property added to and improved was not to be correspondingly increased. *Clearly, therefore, on the face of the transaction, the fund in court represents in equity the income which belongs to the labor and supply creditors as well as the mortgage security, and there was no impropriety in appropriating it as far as necessary to pay the creditors specially provided for when the receiver was appointed. Such a practice, under proper circumstances, was approved in Fosdick* v. *Schall, ubi supra, and seems to us eminently just."*

It has been said that the language found in

Kneeland v. *American Land & Trust Co.,* 136 U. S., 89, and

Thomas v. *Western Car Co.,* 149 U. S., 95,

imposed limitation upon the rules and doctrines of the case of *Fosdick* v. *Schall,* and it is true that Judge Sanborn in *Illinois Trust Co.* v. *Doud,* 105 Fed., 123, so contends in an opinion which produced a vigorous dissent from Judge Caldwell; but the Supreme Court itself has repeatedly said that it adheres to the rules stated in *Fosdick* v. *Schall.* In *Union Trust Co.* v. *Souther,* above cited, it is said "such practice under proper circumstances was approved in *Fosdick* v. *Schall, ubi supra,* and seems to us eminently just." It will also be observed that in *Burnham* v. *Bowen, supra,* the Court said:

> "So far as current expense creditors are concerned, the court should use the income of the receivership in the way the company would have been bound in equity and good conscience to use it if no change in the possession had been made. This rule is in strict accordance with the decision in *Fosdick* v. *Schall, which we see no reason to modify in any particular.*"

The same language is repeated in *Virginia & Alabama Coal Co.* v. *Central R. R. Co.,* 170 U. S., 355; see pages 364-5. Concerning the opinion in this latter case Mr. Justice McKenna in his dissenting opinion in *Gregg* v. *Metropolitan Trust Co.,* 197 U. S., at page 195, says:

> "The admonitions of the Kneeland case and the Thomas case were not overlooked. Regarding them and in connection with them, the Miltenberger

case was quoted from, and not only left undisturbed but approved."

In the case referred to, *Miltenberger* v. *Logansport,* 106 U. S., 286, preferential claims were allowed for the purchase of rolling stock and for the construction of five miles of road and a bridge. The facts of that case are somewhat involved but they are made clear by a review of that case by Mr. Justice White, in *Virginia & Alabama Coal Co.* v. *Central R. R. Co.,* 170 U. S., 356 (page 366). In this latter case, which reaffirms the doctrine of *Fosdick* v. *Schall* and *Burnham* v. *Bowen,* and *Miltenberger* v. *Logansport,* it is said:

"Is there any good reason why the equitable doctrine applied in the cases to which we have referred should not be applied under a state of facts such as shown at bar, where the immediate management of a road was confined by its owners, without protest or interference by the bondholders, to third parties? It would seem not. The dominant feature of the doctrine, as applied in *Burnham* v. *Bowen,* is that where expenditures have been made which were essentially *necessary* to enable the road to be operated as a continuing business, *and it was the expectation of the creditors that the indebtedness created would be paid out of the current earnings of the company,* a superior equity arises in favor of the materialman as against the mortgage bonds in the income arising both before and after the appointment of a receiver from the operation of the property."

The diversion admitted in the case before the Court, was made for the benefit of the mortgagee by the payment of interest on his bonds. But it is not always necessary for the claimant to show that such diversion was for the mortgagee's benefit. Referring to that question, the Court in *Virginia & Alabama Coal Co.* v. *Central R. R. Co., supra,* said:

> "It is immaterial in such case, in determining the right to be compensated out of the surplus earnings of the receivership, whether or not during the operation of the railroad by the company there had been a diversion of income for the benefit of the mortgage bondholders, either in payment of interest on mortgage bonds or expenditures for permanent improvements upon the property. Nor is the equity of a current supply claimant in subsequent income arising from the operation of the railroad under the direction of the court affected by the fact that while the company is operating its road its income is misappropriated and diverted to purposes which do not inure to the benefit of the mortgage bondholders, and are foreign to the beneficial maintenance, preservation and improvement of the property." (Citing several cases.)

This case also distinguishes the Kneeland and Thomas cases which were largely relied upon by appellees in the present cause. All the foregoing cases are reviewed in *Southern Ry. Co.* v. *Carnegie*

Steel Co., 176 U. S., 257. Concerning the Kneeland and Thomas cases, it is said:

> "In neither the Kneeland nor the Thomas case *was there any intention to question the prior decisions of the court,* which allowed priority to claims based upon the furnishing of essential and necessary current supplies, not sold upon mere personal credit, against the surplus income arising during the operation of the road under the direction of a court of equity."

The Carnegie case and the case of

> *Lackawanna Iron & Coal Co.* v. *Farmers Loan & Trust Co.,* 176 U. S., 298,

were decided on the same day. In both cases the claim was for rails furnished to the railroad company. In the Carnegie case the claim was allowed, and in the Lackawanna case the preference was denied. A summary of the reasons for the denial of the claim in the Lackawanna case is found in the concluding paragraph of the opinion. It will be seen that the magnitude of the claim in that case was so great that it amounted practically to reconstruction of the entire railway system; that the claimant had demanded and received collateral security from the railroad company, both of which circumstances indicated that it was not a claim which was intended or understood could be paid from the current income. On the other

hand, in the Carnegie case the Court says, page 290, as follows:

> *"The quantity of rails was not so large as to preclude the expectation that they could be paid for out of the current earnings of the railroad company.* As already said, it was a very small quantity for the purposes of ordinary or necessary repairs and there is nothing in the record to show that the Carnegie Co. relied merely or exclusively on the personal credit of the railroad company."

And again it is said, pages 284-5:

> "It is apparent from an examination of the above cases that the decision in each one depended upon its special facts. * * * * But it may be safely affirmed, upon the authority in former decisions, that a railroad mortgagee when accepting his security impliedly agrees that the current debts of the railroad company contracted in the ordinary course of its business shall be paid out of current receipts before he had any claim upon such income; that, within this rule, a debt not contracted upon the personal credit of the company, but to keep the railroad itself in condition to be used with reasonable safety for the transportation of persons and property, and with the expectation of the parties that it was to be met out of the current receipts of the company may be treated as a current debt; * * * * and *that when current earnings are used for the benefit of mortgage creditors before current expenses are paid,*

the mortgage security is chargeable in equity with the restoration of any funds thus improperly diverted from their primary use."

Referring to the proportion between the claims in this case and the capital and assets of the defendant company, Receiver Markhus testified at the trial that the Idaho Railway Light & Power Company had issued preferred stock for $3,500,000 and common stock for $12,566,200 and the authorized capital was $30,000,000. The complaint shows that the outstanding bonded indebtedness is about $9,000,000. The claims in this case are approximately $21,000 and $26,000, respectively. It appears from the Agreed Statement of Facts *that it was intended that the claims should be paid out of the current operating income, and that this expectation was reasonable appears from the fact that when the funds were diverted on June 1st for the payment of interest to the benefit of the mortgagee, there was on hand a fund derived exclusively from the earnings of the company more than doubly sufficient to pay these claims and the claims of all* others seeking a preference.

Under the rules established by the above decisions, the claims of appellants herein, we respectfully contend, are clearly entitled to a preference, not only for payment from the income which has been diverted, but from the corpus of the property sold. The requirements for charging the corpus of the property with the claim for supplies under the rules established by the

decisions would seem to be that the material and supplies furnished must be of such character as to be necessary to the maintenance and operation of the property; that they have added to and contributed to the value of the property, and the security of the bonds, all of which facts are stipulated in the Agreed Statement of Facts herein.

But these requirements, although present in this case, are not necessary to impose a preference upon the income in case there has been a diversion to the benefit of the mortgagee. In the case of *Gregg* v. *Metropolitan Trust Co.,* 197 U. S. 182, decided by divided Court, the claim was for railway ties which at the time of the appointment of the receiver *had not been* used. The Court said:

> "The case stands as one in which there has been no diversion of income by which the mortgagees are profited, or otherwise."

After showing that under the circumstances the corpus could not be charged with the payment of that particular claim, the Court said:

> "It is agreed that the petitioner may have a claim against surplus earnings, if any, in the hands of the receiver, but that question is not before us here."

We repeat the statement made at the outset that on review of the many cases relating to this question,

we think none can be found wherein preference has been denied to claims possessing all of the elements shown in this case, not only entitling it to be declared a charge upon the corpus of the property itself, but upon the income which was diverted.

DECISIONS FROM CIRCUIT COURTS OF APPEAL.

There have been a number of decisions in the different circuits to which the attention of the Court is respectfully directed. The Circuit Court of Appeals for this Circuit, as before stated, had this question before it in the case of *New York Guaranty & Indemnity Co.* v. *Tacoma Ry. & Motor Co.,* 83 Fed. 365, above quoted. The Court there applied fully the doctrine of *Fosdick* v. *Schall* and *Burnham* v. *Bowen et al.* It was contended that the supplies were not necessary to keep the road a going concern. In other words, it was contended that the doctrine only applied to indispensable supplies or supplies indispensable to the whole service. Referring to that matter, the Court said, page 369:

> "It is true that the Supreme Court has repeatedly declared that preferential claims would be allowed but within very narrow limits, and has time and again admonished the Circuit Courts that such claims would be limited to wages of employes, supplies necessary for the maintenance of the road, and current operating expenses essential to keep it

a going concern. *Kneeland* v. *Trust Co.,* 136 U. S. 89, 10 Sup. Ct. 950; *Thomas* v. *Car Co.,* 149 U. S. 93, 13 Sup. Ct. 824; *Bound* v. *Railway Co.,* 7 C. C. A. 322, 58 Fed. 473; *Lackawanna Iron & Coal Co.* v. *Farmers' Loan & Trust Co.,* 79 Fed. 202, and cases there cited. *But it is also true that the application of the general rules as to preferential claims enunciated by the Supreme Court depends to a large degree upon the particular circumstances of each case. Wood* v. *Railroad Co., supra,* and cases there cited. It is upon this ground that we distinguish the many cases cited by counsel for appellants, which would seem to militate against the allowance of the claim in this case as a preferential one. We think, under the circumstances of this case, *that the cable in question, without which, confessedly, this part of the street railway system could not have been kept in operation and as a going concern,* comes within the category of debts which may be preferred over the mortgage indebtedness. We do not think, as contended for by counsel for appellants, that the cable can be regarded in the light of repairs, or for construction or improvements, within the sense of the rules laid down by such decisions as *Railway Co.* v. *Hamilton,* 134 U. S. 296, 10 Sup. Ct. 546; *Thomas* v. *Car. Co.,* 149 U. S. 110, 13 Sup. Ct. 824, and other cases of a like character. The question *here is not so much whether the cable involved in this claim for preference is to be regarded in the light of repairs, or for construction, or as an improvement, or in the nature of materials or supplies furnished; but it depends upon the inquiry*

whether or not it was necessary to keep the road 'a going concern,' within the meaning of this expression as it is used by the Supreme Court in the cases cited above."

The same contention was made in *Railroad Co.* v. *Lamont,* 69 Fed. 23, involving a claim for providing, furnishing, and maintaining waiting rooms for passengers, and office room for ticket agent, and a convenient place for its employees to board and lodge at reduced rates. Judge Caldwell, speaking for the Circuit Court of Appeals, used the following language which was quoted with approval in the Tacoma case just cited:

"To defeat the preferential character of this claim, the Court would have to be satisfied that waiting rooms for passengers and an office for ticket agents are not essential or necessary, at a town of several thousand population, on the Northern Pacific Railroad. We are asked, in effect, to hold that passengers on that road, while waiting to take passage on its train, must endure the rigors of North Dakota climate without shelter, and that its ticket agent must be content with an office on the public commons, and carry his tickets in his pocket or his hat. The road is in straits, financially, but we are unwilling to believe that its business is so unremunerative and its patronage so slender as to justify it in dispensing with waiting rooms and a ticket office at one of the most important towns on its line west of the Mississippi River. Decided by

the strictest rules applicable to this class of cases, the intervener's claim was clearly a preferential debt."

The Circuit Court of Appeals for the Fourth Circuit, in *Virginia Passenger & Power Co.* v. *Lane Brothers,* 174 Fed. 513, had before it a claim closely resembling claims of appellants in this case and almost identical with the Morris claim. In that case the claim was for work undertaken in order to produce power by water instead of by steam, and it was contended that the claim was for construction work and of a character that would not bring it within the doctrine governing preferential claims. The intention of the company was to change from a steam plant to a water plant. The Court held that the claim should be allowed as a preferential claim.

This decision seems directly in point and is, we believe, the latest decision of an Appellate Court on the subject. We quote the syllabus of the case:

"An electric railway and light company contracted with claimant for the improvement of a water power to be used instead of steam at one of its plants, where the equipment was old, unreliable, and liable to break down. The contract provided for monthly payments in 'current funds,' and prior to the corporation's insolvency payments had been made from the general income and charged to 'construction work.' Receivers having been appointed for the corporation, they were ordered to

continue the work on their representation that a failure of the steam plant would stop all the street cars on certain of the lines and throw one of the towns in darkness, and that a completion of the water power would amount to a considerable annual saving in operating expenses. *When the receiver was appointed, the current income was more than sufficient to pay current expenses and the monthly payments under the contract,* and the receivers paid the claimant for the work done after their appointment. *Held,* that the work was not new construction, but a permanent improvement, and hence the contractors were entitled to payment of the indebtedness incurred and unpaid prior to the appointment of receivers as a preferred claim as against mortgagees."

The material and supplies are characterized by the Court there in language which seems to describe accurately the nature of both the Morris and Roebling claims. The Court says, page 517:

"It was not a new construction in the sense that the building of a new railroad, or the building of a new plant, would be, but was, as said by the Judge below, 'something necessary in furtherance of the more effective and economical operation of the existing plant.' "

In another case from the Circuit Court of Appeals a claim of preference was asserted for machinery of the same character as in the Morris claim. See

Central Trust Co. v. *Clarke,* 81 Fed., 269.

In that case the cable company replaced "a large steel gear wheel and pinion for the price of $10,500. Before the gear wheel was completed certain changes appear to have been made in the plants for constructing the same, in consequence of which changes the cost was largely increased." The claim of preference was allowed. The Court, through Judge Sayre, said:

> "We are of the opinion that the intervener's demand falls within the category of claims which have been generally recognized as of a preferential character, and equitably entitled to be paid in advance of the claims of mortgage bondholders. The gear wheel which was supplied by the Midvale Steel Company to the mortgagor company—that is to say, to the Denver City Cable Railway Company—was an important and essential part of its plant, without which the railway company could neither discharge its duties to the public nor realize an income by the use of the mortgaged property. It was necessary for the railway company to purchase a new gear wheel and pinion, in order that its cable road might be kept in operation, and that the company might preserve its franchises, and remain a going concern. The machinery in question enhanced the value of the mortgaged property by as much as such machinery was fairly worth in the market."

In the case of *Illinois Trust & Savings Bank* v. *Doud,* 105 Fed., 123, in an opinion by Judge Sanborn, preference was denied by the Circuit Court of Appeals

for the Eighth Circuit, by a divided Court, Circuit Judge Caldwell writing a vigorous dissenting opinion. But even in that case some of the equitable considerations which commend these claims to a court of equity were wanting. The claim was for money loaned to the corporation, but used for making certain improvements which did not result to the benefit of the mortgagees. The improvements in that case were for the purpose of carrying out a contract which had been and would continue to be a distinct loss to the corporation of at least $2700.00 per annum. The strong dissenting opinion of Judge Caldwell appears to have been cited as frequently as the opinion of the Court.

It should be added that some of the decision of Judge Sanborn in the Doud and other cases is in striking contrast with the decisions of the Supreme Court and of other Federal Courts, as shown by the dissenting opinion of Judge Caldwell and who adds:

> "It was in view of these considerations that the Supreme Court, unlike the majority of this court in the case at bar, has uniformly refused to lay down any fixed and inflexible rule for the application of the doctrine. Every case is left to be determined on its own special equities. In *Fosdick* v. *Schall* the Supreme Court said:
>
> " 'No fixed and inflexible rule can be laid down for the government of the courts in all cases. Each case will necessarily have its own peculiarities, which must to a greater or less extent influence the chancellor when he comes to act.'

"And in *Southern R. Co.* v. *Carnegie Steel Co., supra,* after reviewing the cases, the Supreme Court says:

"'It is apparent from an examination of the above cases that the decision in each one depended upon its special facts. This Court has uniformly refrained from laying down any rule as absolutely controlling in every case involving the right of unsecured creditors of a corporation, whose property is in the hands of a receiver, to have their demands paid out of net earnings in preference to mortgage creditors.'"

And this is again repeated at page 292, 176 U. S., page 358, where it is said:

"'Each case, as already observed, must depend largely upon its special facts.'"

In *Lackawanna Iron & Coal Co.* v. *Farmers' Loan & Trust Co.,* 176 U. S., 298, 315, decided on the same day with the Carnegie Steel Company case, the Court said:

"'The decision in each case has been more or less controlled by its special facts.'"

Much of what is said by Judge Sanborn in the case referred to is dicta, and it seems to us to be marked particularly by its disregard of the equities which have appealed to the Supreme Court and other appellate courts.

The Circuit Court of Appeals for the Sixth Cir-

cuit, in *International Trust Company* v. *Townsend Brick & Contracting Company,* 95 Fed., 850, denied preference in that case for a claim for the construction of an abutment to a new bridge. But in that case, also, the question of displacing the contract lien was involved, as there was no income, either before or after the appointment of a receiver, to be applied to the claim, or that had been devoted for the benefit of the mortgagees. *And in such cases a much stricter rule is applied than where the earnings of the property are sufficient to pay the claim,* and where the corpus of the mortgaged estate may be left intact for the benefit of the mortgagees, notwithstanding the allowance of the claim.

We think it clearly appears from the decision in that case that the claim would have been allowed had there been earnings from which the claim would have been paid. The Court said:

> "But, if there has been no diversion of the current income, either before or after the appointment of a receiver, and no 'surplus income' during the receivership, out of which unpaid debts of the income can be paid, upon what theory can the proceeds of a mortgage foreclosure sale be applied to the payment of such debts against the objection of mortgage creditors? If nothing has been diverted from the 'current debt fund,' if there has been no augmentation of the fund applicable primarily to the satisfaction of the mortgage creditors, is there any just or equitable reason for

requiring the restoration where nothing has been improperly received? We think in such cases the court has no power to displace contract rights, and neither *Fosdick* v. *Schall* nor any of the cases which have followed it afford any sufficient authority, when rightly understood, in opposition to this view. These 'debts of the income' are an 'equitable charge' only upon the 'current income' of the mortgaged railroad. If such debts remain unpaid when the railroad passes into possession of a court of equity, this 'equitable charge' is continued, and attached to the 'surplus income' arising under the receivership. If the surplus income is not applied to the payment of the debts to which it is primarily devoted, *but is expended for the benefit of the mortgagee, as in payment of interest, or in the purchase of property which passes under the mortgage, or in betterments of the railroad itself, an equity arises, as a consequence of such diversion, which will justify a court of equity in requiring the mortgagee to restore to the income that which has been taken away. The power of the Court to displace mortgage liens in favor of such unsecured debts of the mortgagor depends upon the fact that the current income, either before or after the receivership, has been diverted to the benefit of the displaced mortgagee, and the extent to which the corpus of the mortgaged property can be called upon to pay such debts of the income is limited by the amount of the diversion.*"

Referring to the effect of the bondholders being in active management of the railway, an instructive case is found—

Queen Anne's Ferry Co. v. *Railway Co.,* 148 Fed., 41, 162 Fed., 828,

which was affirmed on appeal.

In this case the contention of the bondholders seems to be entirely without equity. It appears that they formed themselves into a syndicate which directed the operation of the railway company, and, we think the evidence shows, directed the purchase of the particular supplies and materials here involved. This indebtedness was created by the bondholders and for their own benefit. After diverting to their own use the current income fund intended for the payment of these claims, they should not be permitted to hold the property which added to the value of the securities without paying for it. The requirements of the company's business made it necessary to purchase it. It was of such a character and the necessity for its use was such that the Court, on applciation of a receiver, would sanction its purchase. Though there are some dicta to the contrary, the same rule of equitable preference is to be observed whether the Court is passing upon a claim contracted before the appointment of receiver, or hearing an application for permission to purchase supplies and make "useful improvements" after the receiver is appointed.

In determining whether claims of this character are for construction or for maintenance and operation, the amount of the improvement or repair must be considered with reference to the magnitude of the enterprise and the value of the system as a whole and not some particular portion of it, and especially in this case where all the properties of the Railway Company constituted an independent system. The Railway Company's outstanding capital was about $16,000,000 in stock and $9,000,000 in bonds. The net income of the company, even after the diversion on June 1st, was approximately three times more than sufficient to pay the preferential claimants. Appellants' claims are relatively small for a corporation of this magnitude.

SUMMARIZING.

It is admitted by the Agreed Statement or by the uncontradicted evidence:

First: That the accounts of the above claimants are correct and are for materials and supplies furnished to a public service corporation;

Second: That the material and supplies were necessary to the continued maintenance and operation of the Railway Company's property;

Third: That they were sold in the belief that they would be paid for out of the current operating income or earnings;

Fourth: That operating income, more than sufficient to pay all claims of preference, was diverted to pay interest on the bonds;

Fifth: That the manager, or head of the syndicate owning the bonds, was the managing director of the Railway Company and had active charge of its financial affairs. We do not urge that this fact constitutes an estoppel, nor is it intended as a charge of bad faith or fraud, but it is an important element to be considered among all of the facts of the case in establishing an equitable preference;

Sixth: That the net operating income, after the diversion, was approximately $160,000, but the $115,000 of earnings diverted on June 1st were never restored;

Seventh: That the Railway Company joined in the application for a receiver on December 23, 1913;

Eighth: That all of said material has become a part of the property, has added to its value and its earnings, has increased the security of the bonds and was a part of the property sold under foreclosure;

Ninth: Considering the amount of the claims and the value of the company's plant, the work done was only a reasonable improvement necessary for maintenance and operation.

Upon the whole, it is submitted that the Court below erred in denying the respective claims of appellants herein for a preference over the mortgage bond-

holders for balance due upon their several claims, and appellants pray that the said decree of said Court in these respects be reversed and this Court render judgment directing that said claims of preference be allowed.

Respectfully submitted.

BEVERLY L. HODGHEAD,

Attorney and Solicitor for John A. Roebling's Sons Company of California, a corporation, and I. P. Morris Company, a corporation.